

**BULGARIA:
MUNICIPAL FINANCE
REFORM STRATEGY**

FINAL REPORT

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EXECUTIVE SUMMARY

PURPOSE AND ORGANIZATION OF THIS STUDY

This report examines the need and the potential for municipal finance reform in Bulgaria. It identifies current opportunities and constraints and recommends a strategy for a possible USAID effort in support of municipal finance reform over the next five years.

The analysis is based on existing documents and interviews with national government officials, with the executive staff of organizations representing local governments and with the experts and consultants of USAID's Local Government Initiative program and those of other relevant donor programs in Bulgaria. Using data on aggregate municipal budgets and on the consolidated national budget provided by the Ministry of Finance, the report also looks at trends in local finance from 1993 to 1997. It relates those trends to the evolution of the national budget and of the economy of Bulgaria during the same period.

Also, the report looks at the factors that might contribute to the success of the reforms, as well as those that could constrain the process over the next few years. The positive factors include the ongoing efforts by representatives of local governments, national government officials and members of Parliament to amend existing legislation on local taxes and fees and to enact a new Law on Municipal Finance. Among the constraints are the current fiscal crisis in Bulgaria and the measures implemented by the Government to address that situation.

Finally, the report recommends a municipal finance reform strategy that has two components. The first is a reform agenda that describes the key areas of reform and ranks them according to their relative importance and to the likelihood that they might be enacted given current and projected fiscal constraints. The second is a series of activities designed to support the reform process and produce practical examples of the positive impact of the early reforms.

Chapter one examines current problems in municipal finance and revenue and expenditure trends in Bulgaria. Chapter two analyzes the principal opportunities and constraints regarding the reform process, and describes the proposed municipal finance reform strategy.

SUMMARY OF FINDINGS AND RECOMMENDATIONS

Evolution of the State of Municipal Finances 1993 - 1997

Some important legislation was adopted between 1993 and 1997. This includes amendments to the Law on Local Self Government and Local Administration and the new

Law on Municipal Property. However, several fundamental laws, including the Law on Local Finances and the amendment to the Law on Local Taxes and Fees, are still pending. Fiscal legislation has tended to shift tax revenues to the national government at the expense of local governments, as occurred when the VAT replaced the turnover tax. There is yet no clear definition of local expenditure responsibilities. National government ministries continue to make decisions that raise local expenditure levels without providing the corresponding new resources.

There has been a steady decline in local revenues and expenditures during the period from 1993 to 1996. The role of local governments in the economy has decreased from 1992 to 1996 by 51 percent as a share of GDP, and 48 percent as a share of the consolidated public sector budget. Local finances have suffered disproportionately from the fiscal crisis that has affected the public sector in general. For example, local expenditures in health and education have suffered a far greater reduction than at the national level. Yet, much of the direct provision of health and education services is financed by local governments.

The Context for Municipal Finance Reform

The Government of Bulgaria is going through a severe budget crisis that will extend beyond 1997. The national government and Parliament must find ways to reduce the public deficit as a percent of GDP. Inevitably, this will require a reduction in expenditures that will affect government services at the local level. Municipalities should support this process by facilitating the participation of local residents in deciding how best to maintain the level and quality of key services, especially health and education. This is not possible under current circumstances. Municipalities do not have authority over their expenditures in these areas. Further, the current system of municipal finances in Bulgaria includes disincentives to sound management of local finances and impairs severely the ability of municipalities to sustain service coverage and improve service quality. Given a higher degree of fiscal autonomy and accountability, municipalities will be in a better position to implement changes in local service coverage and quality that reflect local priorities as expressed directly by their constituents.

Municipal officials have a reform agenda and are well organized to push for reforms. However, the prospects for meaningful change are mixed and difficult to assess. It is possible to implement basic reforms within the next six months, largely in the form of policy decisions reflected in the annual budget law and through administrative measures adopted by key ministries. But, it will take several rounds of legislation and related regulatory changes over several years to implement all the key reforms. This means that it will be important for those most interested in municipal finance reform to have the ability to sustain their efforts.



Structure of the Proposed Strategy

There are five key elements of a municipal finance reform agenda for Bulgaria. They are as follows:

- Implement a transparent and predictable system of fiscal transfers
- Clarify local expenditure responsibilities and authority
- Encourage sound management of local finances
- Enhance local revenues
- Expand local capital investments

The elements are ranked based on a combination of need and feasibility. Generally, those reforms that provide greater local autonomy and accountability appear first. Those that seek to increase local revenues are next in the sequence. Those that address the need to increase local capital spending are last.

Proposed Activities

There are several ways in which USAID can contribute to the municipal finance reform process and produce tangible results. The first is to help the participants in the process establish priorities among the various elements of the reform agenda and show how these elements fit together. The objective should be to build a clear, strong consensus among the participants around this shared agenda. USAID should also offer direct assistance to those involved in drafting the actual reforms. Finally, as the reforms go forward, some limited support for the rapid dissemination to local officials of information on the changes will be useful and important.

CHAPTER I

TRENDS AND PROBLEMS IN MUNICIPAL FINANCE 1991 - 1996

EVOLUTION OF THE LEGAL FRAMEWORK FOR LOCAL SELF GOVERNMENT

When the current transition to local self government began in the early 1990s, several laws were drafted with the objective of providing a coherent framework for national regional policy and local self government. The expectation was that the entire set of laws would be enacted by 1994. However, after the adoption of the Law on Local Self Government and Local Administration in 1991 there has been limited additional progress. The initial idea of adopting all laws relevant to national regional policy and local self government in a single package was never put into practice. Recent local government legislation has tended to address specific, relatively narrow issues. This includes the Law on the Administrative and Territorial Structure and Internal Division of Cities (1995), and the Law on Municipal Property (1996). Although useful, these laws fall short of creating an adequate framework for local self government. Fundamental laws, such as those on Municipal Finance and on Local Taxes and Fees, first proposed in 1995, are still pending.¹ An additional factor that has weakened local governments has been the trend in fiscal legislation to shift tax revenues from local governments to the national government. For example, local governments had been receiving 10 percent of the revenues from the turnover tax. When it was replaced in 1994 by the value added tax, the national government kept 100 percent of the revenues for itself without otherwise compensating local governments.

The decision in 1993 to determine the amount of state transfers for municipalities by formula was a potentially important development. In theory, once the amount of the transfer for each municipality was determined by applying objective, quantitative criteria, there would be no further need to compensate for local shortfalls of revenues over expenditures. In practice, there continues to be a common belief among the national and local government officials that there is a need for transfers to subsidize local budget deficits. This puts local governments in an unfavorable position. Originally planned for gradual adoption over a five-year period, the formula-based mechanism has been made increasingly complex as a result of annual modifications. It is abandoned frequently for the sake of "manual steering." This leads to a lack of transparency and makes it very difficult for local governments to determine in advance the amount of the transfer they will receive.

ASSIGNMENT OF EXPENDITURE RESPONSIBILITIES

¹ As this report was being finalized, the Parliament adopted the Law on Local Taxes and Fees. It was not possible to obtain a copy of the law in time to discuss it in the report.

Table 1 shows the expenditure responsibilities of different levels of government as of 1996. Local governments largely have been assigned responsibilities for services which have a local benefit area, such as primary and secondary schools, health care and sanitation.² However, this does not mean that local governments have full control over these expenditures. For example, the national government sets uniform wage scales that apply to all employees in sectors such as health and education, including those on the payroll of local governments. Since labor costs represent the largest share of total expenditures in these sectors, any change in the national wage scale has a significant impact on local expenditures. In addition, local governments may not decide of their own initiative to reduce the level of services in these sectors. In order to survive, local governments often are forced to defer payment or to make short-term, non-interest bearing loans to themselves from extra budgetary funds to cover unplanned increases in expenditures.

Changes in expenditure responsibilities between 1993 and 1996 are indicated in italics in Table 1. In most cases the assignment of responsibilities today remains as it was then. Responsibility for water and sewerage has shifted from state enterprises to limited liability companies in which the national government owns the majority of shares and local governments a minority. The only other substantial change has been the privatization of most local public transportation.

² Exceptions to this rule are certain schools, hospitals and public establishments, located in highly populated municipalities. These large institutions also service citizens of neighboring smaller municipalities.



Table 1
Expenditure Assignments, Bulgaria, 1996

Category	Central Government	Municipality	Settlement
Defense	<ul style="list-style-type: none"> Entire responsibility 		
Justice/Internal security	<ul style="list-style-type: none"> Entire responsibility 		
Foreign economic relations	<ul style="list-style-type: none"> Entire responsibility 		
Education	<ul style="list-style-type: none"> All universities and research institutions Some technical and vocational schools 	<ul style="list-style-type: none"> All expenditures (capital and current) of primary and secondary schools Some kindergartens Some technical and vocational schools 	<ul style="list-style-type: none"> Some kindergartens
Health	<ul style="list-style-type: none"> Research medical institutions Some special service hospitals 	<ul style="list-style-type: none"> Homes for elderly population Tertiary care and psychiatric hospitals Polyclinics Some primary care Some special service hospitals Medicine 	<ul style="list-style-type: none"> Some primary health facility
Roads	<ul style="list-style-type: none"> Construction of all roads Maintenance of state highways and roads linking cities & villages 	<ul style="list-style-type: none"> Maintenance of third- and fourth- class roads and urban streets 	<ul style="list-style-type: none"> Maintenance of local networks
Public Transportation	<ul style="list-style-type: none"> Airport Railway subsidy 	<ul style="list-style-type: none"> <i>Subsidy to some inter village bus service within municipalities (most have been privatized)</i> 	
Fire Protection	<ul style="list-style-type: none"> <i>All fire protection service</i> 		
Libraries	<ul style="list-style-type: none"> National libraries 	<ul style="list-style-type: none"> Local libraries 	

Table 1 (Continued)

Category	Central Government	Municipality	Settlement
Sanitation		<ul style="list-style-type: none"> • Part of garbage collection and street cleaning 	<ul style="list-style-type: none"> • Part of garbage collection and street cleaning
Water and Sewerage	<ul style="list-style-type: none"> • <i>Limited liability or joint stock companies (with the national government having majority share) constructing and operating the water mains</i> 	<ul style="list-style-type: none"> • <i>Municipal owned companies</i> • Some construction (via targeted subsidy from the national government) and operation • Water supply infrastructure for the inner city 	<ul style="list-style-type: none"> • Some operation (primarily repairs)
Heating		<ul style="list-style-type: none"> • Municipal owned enterprises • Operation and maintenance of the service • Heating subsidy from the municipality to cover losses and differences in prices 	
Electricity	<ul style="list-style-type: none"> • State owned enterprise covering the full range of service • Some state subsidy 		
Housing		<ul style="list-style-type: none"> • Financing for low income population • Construction by private and municipal/national enterprises • Subsidy for maintenance of residential housing 	
Price Subsidies		<ul style="list-style-type: none"> • Mass transport • Medicine (for old, disabled, children, chronic disease) 	



Table 1 (Continued)

Category	Central Government	Municipality	Settlement
Enterprises in Productive Sector		<ul style="list-style-type: none">• Capacity to invest in joint ventures, including banks• Keep all proceeds from privatization of municipal enterprises	
Environment	<ul style="list-style-type: none">• Responsible for national environmental issues	<ul style="list-style-type: none">• Responsible for local environmental issues	
Enterprises	<ul style="list-style-type: none">• National enterprises (including most types of industry)	<ul style="list-style-type: none">• Local and municipal enterprises (transport, construction, and other local economy services)	

Note: Table was updated from 1993 to 1996. Italics show the changes since 1993.

Source: Table 5.1 Expenditure assignment in Bulgaria, 1993. From "Intergovernmental fiscal relations in Bulgaria" by Jorge Martinez-Vazquez in *Decentralization of the Socialist State. Intergovernmental Finance in Transition Economies* Edited by Richard M. Bird, Robert D. Ebel and Christine I. Wallich. Washington, D.C.: The World Bank. 1995.

Table 2 examines the share of local expenditures in total consolidated expenditures³ across sectors.⁴ Of those sectors in which both the national and local governments are involved, local expenditures account for the larger share in education, health, and housing and communal services. There are differences among municipalities in the allocation of expenditure. The larger municipalities allocate a higher share for health care, while smaller municipalities allocate relatively more to education.⁵ The relative share of expenditures in the different sectors has remained approximately the same across the years.⁶

In 1993, local expenditures as a percent of total consolidated expenditures for education, health and social welfare were 70, 70, and 80 percent respectively.⁷ In 1996 these shares decreased to 55, 59, and 46 percent respectively. The capital expenditure responsibility of local governments has also been decreasing over the years. In 1993, local capital expenditures as a percent of total consolidated capital expenditures in education, health and social services sectors were 53, 65 and 52 percent respectively.⁸ These declined to 6, 25, and 15 percent respectively in 1996.

The decrease in local expenditures in the education, health, and housing and communal sectors may be partly due to structural changes in the economy, of which there have been two types: (1) a decrease in the number of social care institutions financed by municipal budgets due to a decreasing population growth rate; and (2) restructuring of the health and education sectors which has resulted in the closure of several inefficient hospitals and schools as well as shifted financing for several of these institutions to the national government.

³ This includes all expenditures of the national government ministries, the judiciary and local governments, as well as for social security benefits.

⁴ Since expenditures in the education, health, housing and communal, and social sector account for a large percent of local expenditures (85 percent in 1996) we have focused our analysis on these sectors.

⁵ See Table 5 at the end of this chapter.

⁶ Table 4 shows the breakup of local government expenditures by sector and local government revenue by source from 1991 to 1996.

⁷ From Jorge Martinez-Vazquez "Intergovernmental Fiscal Relations in Bulgaria." 1995. *Intergovernmental Fiscal Relations in Transition Economies*. Edited by Richard Bird, Robert Ebel and Christine Wallich. Washington D.C.: The World Bank.

⁸ From Jorge Martinez-Vazquez "Intergovernmental Fiscal Relations in Bulgaria." 1995.



Table 2
Consolidated Fiscal Expenditures and Decentralized Expenditures by Function, 1996 (million leva)

Category	General Admin	Defense	Police and Fire	Education	Health	Social Security	Social Assistance	Social Welfare	Housing Comm Dev	Recr and Culture	Trans and Comm
<i>Expenditures (of which)</i>	26,472	41,362	24,651	63,357	55,973	118,224	38,511	9,475	22,000	9,336	16,953
National	19,718	41,362	24,214	28,576	23,074	118,224	33,167	5,140	4,253	6,116	13,431
Local	6,754	–	437	34,781	32,899	–	5,344	4,335	17,747	3,220	3,522
Local as % of national	25.51	–	1.77	54.90	58.78	–	13.88	45.75	80.67	34.49	20.78
<i>Investments (of which)</i>	1,598	557	1,446	5,658	2,196	–	–	115	5,884	482	3,425
National	1,433	557	1,446	5,308	1,651	–	–	98	712	462	3,425
Local	165	–	0	350	545	–	–	17	5,172	20	–
Local as % of national	10.33	–	0.00	6.19	24.82	–	–	14.78	87.90	4.15	–

Source: Ministry of Finance, Bulgaria

Table 3 shows the trends in education and health expenditures at the national and local levels. Despite large increases in nominal terms in both sectors, the expenditures expressed as a percent of GDP at both the national and local level decreased between 1993 and 1996. The reduction at the local level was far greater in relative terms. Yet, it is at the local level that much of the direct provision of health and education services is financed.

Table 3
Local and Central Government Expenditures as a Percent of GDP in Education and Health

Level of Government	Education			Health		
	1993	1996	Change	1993	1996	Change
Central	5,636 1.9%	28,576 1.7%	507% (9%)	4,973 1.7%	23,074 1.4%	464% (16%)
Local	12,871 4.3%	34,781 2.09%	270% (52%)	11,638 3.9%	32,899 2.0%	283% (49%)

Note: GDP (in millions of leva) in 1993 was 298,934, and in 1996 it was 1,660,200.

REVENUE SOURCES

Local governments have two main sources of revenue: shared tax revenues and transfers.⁹ Shared tax revenues include 6.5 percent of the company profit tax, and 50 percent of the personal income tax.¹⁰ Revenues from excise tax and customs duties are also shared but they account for a very small portion of local revenues. In 1991, shared tax revenues accounted for 72 percent of total local revenues from all sources. The proportion decreased to 33 percent in 1994 before rising to 36 percent in 1995 and 44 percent in 1996. Revenue sharing is based either on a derivation basis (profit tax)¹¹ or origin basis (personal income tax).¹² The percent of total revenues from these taxes that is shared with the local government has changed and decreasing since 1992. This has

⁹ In Bulgaria, local governments refer to all tax and non-tax revenues as "own revenue". This is irrespective of the fact that some of the taxes are shared, and that local governments have no authority in setting the tax rates (except for local fees which are set by the Municipal Council within an upper and lower bound determined by the Ministry of Finance.)

¹⁰ Until January 1994, local governments received 10 percent of the turnover tax. This tax was replaced by the value added tax (VAT) which is not shared with the local governments.

¹¹ Some proportion of the amount collected in the jurisdiction of a local government is returned to the local government.

¹² The taxes are shared based on the location of employment, not on the location of residence.

made it very difficult for local governments to forecast their annual revenues. Transfers from the central government also account for a significant proportion of local revenues, although their relative weight has been diminishing. Transfers reached a high of 48 percent of local revenues from all sources in 1993. Since then they have been steadily declining until reaching 33 percent in 1996.

Revenues from local taxes and fees are subject to numerous constraints that minimize their potential impact. For example, the MOF has responsibility for administration of all taxes, including those imposed under the authority of local governments. Traditionally, the MOF has concentrated its efforts on collecting taxes from the larger taxpayers. Local taxes receive less attention. Local governments do not always receive timely information on the amounts assessed and collected on their behalf by the MOF. Often, local governments learn of the amounts collected when the funds are deposited in their bank accounts. The real estate tax is based on valuations of property established many years ago, which were never updated to adjust for inflation. These taxes account for only 1 percent of local revenues. Although local governments can retain the full proceeds from the privatization of their assets, there are constraints on how these funds may be used. Many local fees, which are subject to uniform national caps, are insufficient to recover the full cost of providing the corresponding services.¹³ Conversely, local governments sometimes set service fees below the maximum allowed, with the expectation that the state budget will subsidize any losses.¹⁴ The share of non-tax revenues is small, although it has been increasing. In 1993 fees accounted for only 3 percent of local revenues. By 1996 they had increased to 9 percent.

These figures refer to the average structure of revenues by source for all municipalities. In fact, there are significant differences among municipalities. They can be classified into three groups with different revenue characteristics. The first group includes those small municipalities (some 5 to 8 in all) where large enterprises are located. These municipalities receive substantial revenues from their share of the profit and income tax, which are distributed to the jurisdictions where they are collected. This group of municipalities is not entitled to state subsidies. In fact, they have to contribute to the state budget. The second group includes the large urban municipalities (approximately 30) whose more highly developed economy generates a relatively steady flow of own revenues. The third group, which includes all remaining municipalities, is heavily reliant

¹³ This does not apply to all services. For example, local governments have full discretion to set fees for solid waste collection and to determine the rent on municipal property.

¹⁴ For example, a municipality whose cost of providing a service is 1500 leva and which has the right to set a fee of anywhere between 200 and 600 leva, may decide to limit the fee to 250 leva even though this will increase their losses. The municipality prefers to bet that it will receive a higher amount of transfers that it can use to subsidize the service rather than face possible local opposition to the higher fee.



on transfers from the state budget which can represent as much as 80 percent of total revenues.

Table 4
Local Government Revenues and Expenditures in Nominal Bulgarian Leva ('000)

<i>Revenues</i>	1991	Jan-June 1992	1993	1994	1995	1996
Tax Revenue (2+3)	11,309,700 73.2%	6,189,900 57.2%	16,530,000 47.8%	17,075,567 35.0%	26,070,697 38.0%	52,994,779 47.0%
Shared Rev. (2)	11,175,500 72.3%	6,090,400 56.2%	16,127,700 46.7%	15,980,358 32.7%	24,332,893 35.7%	49,813,388 44.5%
Other Tax Rev. (3)	134,200 0.9%	99,500 0.9%	402,300 1.2%	1,095,209 2.2%	1,737,804 2.5%	3,181,391 2.8%
Non-Tax Rev. (4+5)	546,400 3.5%	1,093,500 10.1%	1,338,100 3.9%	8,499,581 17.4%	12,334,128 18.0%	19,941,387 17.8%
Fees (4)	245,900 1.6%	226,000 2.1%	942,500 2.7%	4,896,794 10.0%	6,396,979 9.3%	9,713,008 8.7%
Other Non-Tax Rev. (5)	300,500 1.9%	867,500 8.0%	395,600 1.1%	3,602,788 7.4%	5,937,149 8.7%	10,228,379 9.1%
Transfers	3,595,900 23.7%	3,546,900 32.8%	16,684,800 48.3%	21,705,480 44.4%	28,808,430 42.0%	37,099,227 33.1%
Borrowing (6+7+8)	na	na	na	1,648,407 3.4%	1,291,316 1.9%	2,041,742 1.8%
Temporary Non-Int. (6)	—	—	—	766,446 1.6%	881,767 1.3%	2,103,311 1.9%
Int. Bearing fr. Fin. Insti. (7)	—	—	—	683,388 1.4%	82,057 0.1%	-74,200 -0.1%
Bonds (8)	—	—	—	198,572 0.4%	327,492 0.5%	12,631 0.0%
Total	15,452,000 100.0%	10,830,300 100.0%	34,552,900 100.0%	48,929,035 100.0%	68,504,571 100.0%	112,077,135 100.0%
<i>Expenditure</i>	1991	Jan-June 1992	1993	1994	1995	1996
Education	5,023,000 33.8%	3,343,000 32.5%	12,871,000 37.0%	15,804,660 32.5%	21,989,619 32.4%	34,780,633 31.2%
Culture	419,000 2.8%	245,000 2.4%	1,006,000 2.9%	1,395,786 2.9%	2,115,053 3.1%	3,185,406 2.9%
Health Care	4,135,000 27.9%	3,023,000 29.4%	11,638,000 33.5%	15,010,007 30.9%	20,681,337 30.5%	32,505,260 29.2%
Housing & Communal	2,482,000 16.7%	1,797,000 17.5%	3,320,000 9.6%	8,103,934 16.7%	10,960,457 16.2%	17,747,105 15.9%
Social Welfare	1,054,000 7.1%	836,000 8.1%	3,632,000 10.5%	4,707,774 9.7%	6,367,033 9.4%	9,678,484 8.7%
Local Admin.	637,000 4.3%	390,000 3.8%	1,104,000 3.2%	2,630,631 5.4%	4,077,951 6.0%	6,754,192 6.1%
Other	1,092,000 7.4%	638,000 6.2%	1,201,000 3.5%	991,851 2.0%	1,615,729 2.4%	6,775,591 6.1%
Total	14,842,000 100.0%	10,272,000 100.0%	34,772,000 100.0%	48,644,643 100.0%	67,807,179 100.0%	111,426,671 100.0%

Source: Numbers for 1991—1993 are from Table 5.3 and 5.4 of “Intergovernmental Fiscal Relations in Bulgaria.” by Jorge Martinez-Vazquez. Numbers for 1994—1996 are from the Ministry of Finance, Bulgaria.

COMBINED REVENUE AND EXPENDITURE ANALYSIS

Figure 1
Local Government Real Revenues and
Expenditures in 1996 Leva

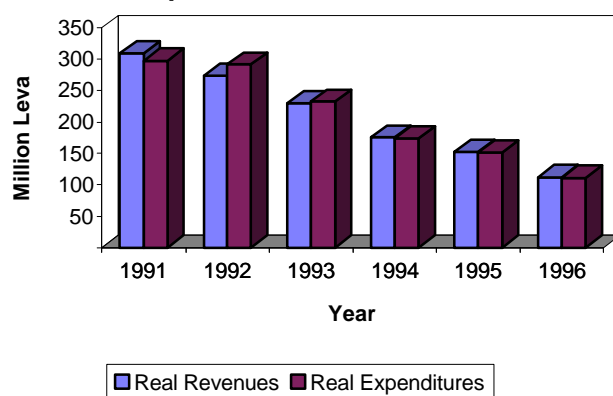
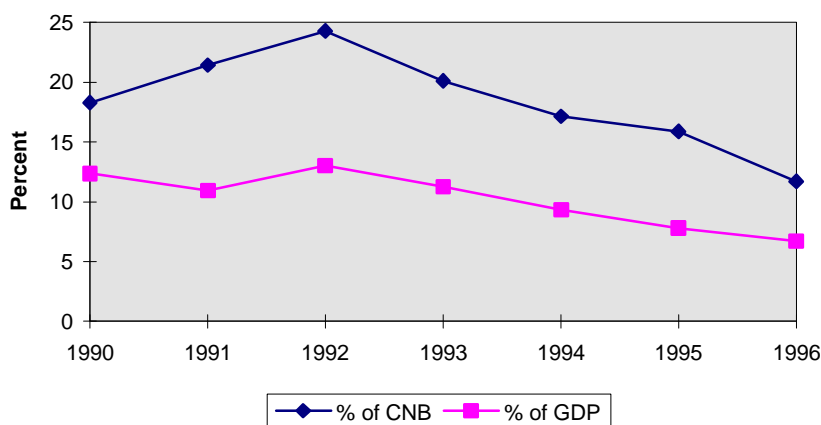


Figure 1 shows the trend in local government revenues and expenditures from 1991 to 1996 expressed in constant 1996 leva.¹⁵ Both declined during this period. Expenditures exceeded revenues in 1992 and 1993.

Figure 2 shows the steady decline in local expenditures, expressed as a percent of the consolidated national budget (CNB) and of gross domestic product (GDP). Since 1992, the relative weight of local government expenditures in the public sector and in the economy has decreased by 51 and 48 percent, respectively.

Figure 2
Local Expenditures as a % of CNB and GDP

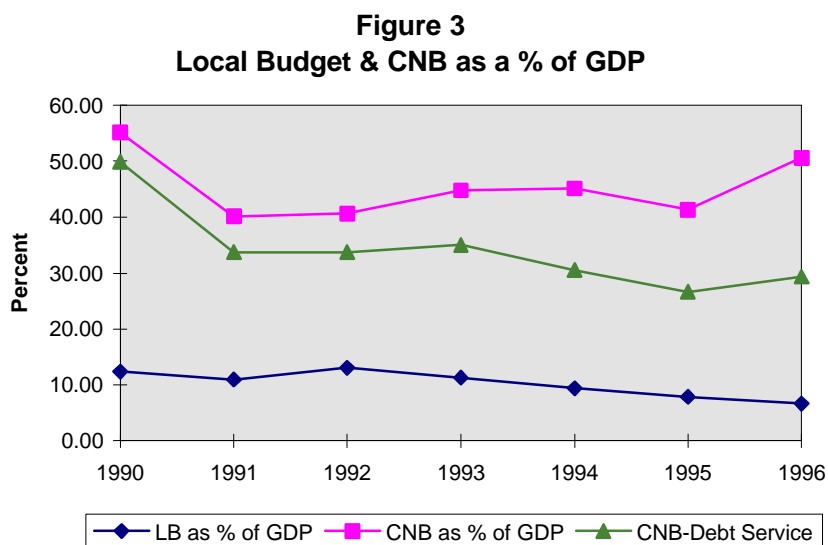


¹⁵ The consumer price index (CPI) was used to inflate values to 1996 prices rather than deflate values to 1991 on the assumption that the calculation of the CPI has become more accurate in recent years.



Figure 3 shows both local and consolidated national budget expenditures as a percent of GDP. It also shows CNB minus debt service as a percent of GDP. Local expenditures have been compromised when compared to central expenditures—central expenditures show an positive trend after 1992, but local government spending shows a negative trend.

When we compare local expenditure as a percent of GDP with CNB minus debt service as a percent of GDP, the disparity in the spending trends of central and



local governments is not as severe. However, a divergence in the trends of local and national expenditures is still apparent between 1992 and 1993 and between 1995 and 1996, when national government expenditures increased and local expenditures decreased.

Table 5 presents a variety of socioeconomic and fiscal data for local governments grouped according to the size of their population for 1996. An interesting number is the uniformity of expenditures per capita on education across all sizes of municipalities. Health care expenditures per capita tend to be much higher in the larger municipalities, probably reflecting the concentration of regional medical facilities in those jurisdictions. Sofia and the smallest municipalities had the highest total per capita expenditures.¹⁶

¹⁶ "The Decentralization of Local Government in Bulgaria." 1994. Prepared by KPMG Peat Marwick Policy Economics Group for the National Center for Regional Development and Housing Policy, Ministry of Regional Development and Construction.

Table 5
Aggregate Data for Local Governments According to the Size of Population, 1996

Category	1,000 to 5,000	5,000 to 10,000	10,000 to 50,000	50,000 to 100,000	100,000 to 500,000	Sofia	National Aggregate
<i>Socio Economic Indicators</i>							
Number of Municipalities	22	60	139	21	12	1	255
Total Population	76,950	465,703	2,994,275	1,549,998	2,064,969	1,189,043	8,340,938
% of Population	0.92	5.58	35.90	18.58	24.76	14.26	100.00
% of Population < age 18	13.12	17.03	37.54	18.98	18.90	16.40	18.61
% of Population > age 60	43.65	36.08	27.71	21.61	19.64	22.51	24.45
18 < % of Population < 60	43.23	46.89	52.83	59.39	61.45	61.09	56.94
<i>Revenues as a Percent of Total Municipal Expenditure^a</i>							
Tax Revenue	31.41	36.31	34.72	48.47	53.29	65.31	47.62
Shared Tax Revenue	30.03	35.22	32.78	46.25	49.44	60.99	44.76
Other Tax Revenue	1.38	1.09	1.94	2.23	3.85	4.31	2.86
Non-Tax Revenue	21.67	11.59	14.67	16.60	20.78	22.50	17.92
Fees	4.72	5.56	6.84	8.07	10.22	11.75	8.73
Other Non Tax Revenue	16.95	6.03	7.83	8.53	10.56	10.76	9.19
Transfers	49.83	52.04	50.02	34.03	23.60	11.04	33.33
Borrowing	0.85	1.05	1.66	1.56	2.50	1.75	1.83
<i>Percent Distribution of Expenditures by Sectors</i>							
Education	26.59	29.93	36.44	31.87	30.35	23.48	31.21
Culture	3.67	2.92	2.92	3.29	3.11	1.84	2.86
Health Care	10.29	15.57	23.96	37.48	37.83	22.16	29.17
Housing	28.14	18.91	13.54	12.06	13.80	25.59	15.93
Social	10.75	12.96	11.73	7.82	7.28	4.89	8.69
Local Admin.	11.45	11.58	8.36	5.11	4.19	3.72	6.06
Other	9.11	8.13	3.06	2.37	3.44	18.32	6.08
<i>Per Capita Expenditure by Sectors</i>							
Education	4,219.10	4,176.09	4,138.66	4,253.91	4,319.92	3,872.72	4,192.68
Culture	582.11	408.06	332.18	438.86	442.58	304.26	387.86
Health Care	1,633.62	2,172.06	2,720.71	5,003.31	5,384.83	3,655.76	3,915.60
Housing	4,465.35	2,638.04	1,537.49	1,610.14	1,964.44	4,221.09	1,967.05
Social	1,706.39	1,808.83	1,331.94	1,044.32	1,036.01	806.18	1,187.54
Local Admin.	1,817.67	1,615.57	949.27	682.32	597.02	613.23	824.85
Other	1,445.90	1,134.04	347.20	316.76	489.90	3,022.59	642.70
Total	15,870.15	13,952.68	11,357.45	13,349.61	14,234.71	16,495.83	13,118.27

Note

^a The grouping of local governments into population groups does not capture the fact that there exist some very small local governments which earn very high tax revenues which are then contributed to the central government.

Source: Ministry of Finance data, Bulgaria.

CHAPTER II

MUNICIPAL FINANCE REFORM STRATEGY

THE CONTEXT FOR MUNICIPAL FINANCE REFORM

The Need for Change

Bulgaria had a budget deficit equivalent to 11.7 percent of GDP in 1996. The target for 1997 is a deficit equivalent to 6.2 percent of GDP. The preliminary target for 1998 is around 3 percent. Meeting these targets will require a massive contraction of public expenditures over three years. Bulgaria has adopted the use of a currency board, with the *Leva* pegged to the German mark, to ensure that there will be the necessary fiscal discipline. As payment of the internal and external debt and growing unemployment benefits claim a larger share of the diminishing public budget, those expenditures that are primarily the responsibility of municipalities, such as health and education, will come under intense pressure. This will require, inevitably, very difficult choices that will entail significant changes in these important services.

Municipalities should play a major role in this process. They are in a unique position to provide a vehicle for local residents to participate in making the difficult choices affecting level and quality of key government services, especially health and education. That is not possible under current circumstances. Municipalities do not have authority over their expenditures in these areas. Further, the current system of municipal finances in Bulgaria includes disincentives to sound management of local finances and impairs severely the ability of municipalities to sustain service coverage and improve service quality. Given a higher degree of fiscal autonomy and accountability, municipalities will be in a better position to implement changes in local service coverage and quality that are required as a result of the ongoing fiscal crisis and that reflect local priorities as expressed directly by their constituents.

Opportunities and Constraints

Municipal officials have a clear reform agenda and are well organized to push for reforms. Interviews with the National Association of Municipalities, the Foundation on Local Government Reform and with the National Association of Public Finance Officers confirmed that these organizations have clear, well-articulated views on municipal finance reform. Much of their attention at this time is centered on the Law on Local Taxes and Fees and on the Municipal Finance Law. The fact that these two laws already are in advanced stages of drafting and discussion adds to the likelihood of some action in this area.

National government officials and members of Parliament are willing to support the reforms. However, they do not appear to have a reform agenda of their own. Further, it

is highly likely that measures to address the national fiscal crisis will take precedence over municipal finance reforms. This already is evident in the legislative agenda for the balance of 1997, which is burdened with an ambitious agenda of laws to address various aspects of the ongoing adjustment process.

An additional complicating factor is that key aspects of municipal finance reform will depend on the success of many of the key measures involved in the overall adjustment process, such as reforms to the national tax system and health and social programs. These reforms are extremely complicated and will take time to enact and implement. Municipal financial reform cannot be completed until these other initiatives have produced initial results.

Prospects for Change

The prospects for municipal finance reform are mixed and difficult to assess. It is possible to implement basic reforms within the next six months through policy decisions reflected in the annual budget law and amendments to existing regulations. These measures can have a positive impact on municipal finances and services achieved largely through efficiency gains made possible by increased local autonomy.

But, it will take several rounds of legislation and related regulatory changes over several years to implement all the key reforms. For example, given the claims on scarce national budget revenues of key items such as debt service and unemployment insurance, a major increase in municipal revenues is unlikely until budget year 1999 or later. Those improvements in municipal finances that depend on the reforms in health and social programs also will take many years. Health reform involves a major restructuring of the sector with a shift toward financing through individual insurance. The resources needed to capitalize the new health insurance fund are not available. Finally, it will not be possible to achieve a sustained increase in local investment levels until all these other reforms take hold and municipalities are able to generate a consistent operating surplus.

MUNICIPAL FINANCE REFORM STRATEGY

Key Elements of the Reform Agenda

There are five key elements of a municipal finance reform agenda for Bulgaria. They are as follows:

- ! Implement a transparent and predictable system of fiscal transfers
- ! Clarify local expenditure responsibilities and authority
- ! Encourage sound management of local finances
- ! Enhance local revenues

! Expand local capital investments

The elements are ranked based on a combination of need and feasibility. Generally, those reforms that provide greater local autonomy and accountability appear first. Those that seek to increase local revenues are next in the sequence. Those that address the need to increase local capital spending are last. The discussion that follows describes each element in greater detail. It also provides the rationale for the proposed sequencing of the reforms. Finally, it also attempts to identify those reforms that might require changes in legislation.

1. Implement a Transparent and Predictable System of Fiscal Transfers

Both national and local government officials seem to view fiscal transfers from the state budget as a mechanism to finance local budget deficits caused by the shortfall of local revenues over local expenditures. This creates an incentive for local government officials to address their budget problems by seeking larger transfers from the state budget. Among national government officials it creates the impression that municipalities are subsidized by the state budget. In effect, both view the revenue side of municipal budgets as “open-ended.” Total municipal revenues become largely a function of planned expenditures. Under such a system it is impossible to hold municipalities accountable for failing to balance revenues and expenditures.

Before there can be true local fiscal autonomy and accountability, there is a need to transform the current system of open-ended transfers from the state budget to local governments into a transparent and predictable system of fiscal transfers. The first step is to establish and adhere to clear rules that determine in advance how much any given municipality will receive from the state budget in the form of transfers. This implies that the criteria and the corresponding formula to establish the amounts of fiscal transfers should not be subject to discretionary changes made by the national government. The main objective of fiscal transfers should be to compensate to some degree for existing differences in expenditure needs and fiscal capacity among local jurisdictions. In order to ensure stability, the rules governing the fiscal transfer system should be established by law. This should make annual budgetary appropriations for transfers more consistent and predictable. When municipalities are reasonably certain of the amount of fiscal transfers they can expect from the state budget they will find it easier to prepare a balanced budget. Well-defined limits on the total value of fiscal transfers to municipalities also will simplify the management of the state budget.

A system of fiscal transfers based on objective criteria and a consistent formula probably will generate winners and losers among the municipalities. For example, an adequate fiscal transfer formula should be based on indicators of actual expenditure needs, rather than on current expenditure levels. Since the existing formula does not meet this premise, it is reasonable to expect that some adjustments in the current level of

transfers will be necessary when establishing a new system. In order to make the transition smooth, those municipalities that would face severe reductions in the level of fiscal transfers may need to receive compensatory transfers that should decrease gradually over a specified time period.

Bringing an end to “open-ended” municipal budgets is necessary condition to achieve local fiscal accountability and discipline without which the success of other elements of the municipal finance reform agenda will be difficult to achieve. When there is a presumption that local deficits will be covered by transfers from the state budget, there is little incentive to save and to mobilize own local revenues. This is why the reform of the system of fiscal transfers is presented first among the various elements of the reform agenda.

Immediate Reforms. The first step is to amend the existing formula governing fiscal transfers to make it more objective and transparent. The revised formula can be adopted as part of the state budget law for 1998. It should include specific criteria to measure local health and education expenditure needs as well as the difference in fiscal capacity across municipalities. The formula should be published in draft form in advance of the approval of the state budget to provide an opportunity for comment and discussion by the representatives of municipalities. The objective should be to produce a formula that is easily grasped and applied by local government officials and that provides them a basis to project with reasonable certainty how much they will receive in the form of fiscal transfers in the upcoming year.

Legal Reforms. The next step should be to draft and adopt legislation during 1998 that formalizes the rules governing fiscal transfers to ensure greater stability in the system. Concurrently, the law should establish the right and responsibility of municipalities to prepare and approve their own balanced budgets, independent of the national budget. The Ministry of Finance would review planned municipal budgets only to monitor the accurate and correct application of the fiscal transfer formula and to develop an estimate of aggregate fiscal transfers to include in the proposed national budget.

2. Clarify Assignment of Expenditure Responsibilities

Clearly defined revenues based on predictable fiscal transfers is a necessary but insufficient condition to promote sound local financial management. Municipal governments also must have the authority to decide the level of expenditures in their budget. This is true particularly in the case of health and education. Continued intervention by national government ministries in determining the level of expenditures in health and education makes it difficult to hold the municipalities accountable for failing to balance revenues and expenditures.

Consequently, a main objective of the strategy should be to make sure that there is a clear division of expenditure responsibilities between the national and local governments that includes a corresponding level of authority to plan and implement the expenditures.

Immediate Reforms. Current regulations of the Ministry of Health and Ministry of Education should be amended to give more authority to municipalities in those aspects of health and education expenditures over which they have responsibility. To the extent the legislation does not allow significant delegation of authority, it would be important to amend the laws to add language to make this possible. There is a precedent for such language in recent legislation. This is much less complex than trying to undertake a major reform of the entire legislation in the area of health and education. Finally, it would be useful to add a policy statement to the 1998 state budget law indicating that the national government will not adopt decisions that increase local expenditures without also including provisions to make available additional resources to pay for those expenditures. The implementation of this policy may be very difficult. At least the intent will be clear. Affected municipalities would know that they should discuss any apparent violation of the spirit of this policy with the national government.

Legal Reforms. Any new legislation to reform the health and education sectors must include a clear assignment of expenditure responsibilities. The legislation also should provide adequate authority to municipalities in their area of responsibility. For example, if municipalities retain responsibility for delivery of basic health and education services in the new legislation, they should also have commensurate authority to hire and fire key staff in charge of managing these services. The new legislation also should formalize the prohibition against unfunded mandates that would have been adopted initially as a policy statement in the annual budget law.

3. Encourage Sound Management of Local Finances

Greater control by municipalities over revenues and expenditures will create conditions in which they are able to make efficient, responsive, and accountable choices in the use of scarce budget resources. The higher degree of autonomy also should make them politically accountable to local constituents for maintaining the coverage and improving the quality of municipal services. Municipal finance reform can provide additional tools to promote the sound management of local finances. Such tools should include greater local authority to administer and collect local taxes and fees. They should include rewards for efficiency gains to encourage cost savings. They also should promote more open and transparent management of local finances.

Immediate Reforms. There are a few reforms that can be implemented in the short run. The revisions to the formula governing fiscal transfers discussed above would mitigate one of the strongest existing disincentives to efficient administration of local

revenues. For example, the current formula penalizes those municipalities that succeed in raising more revenues from local taxes by reducing the amount of the transfers they receive. The revised formula would compensate for differences in local fiscal capacity not fiscal performance. In addition, the Ministry of Finance can take steps immediately to share tax assessment and collection information with municipalities on a more timely and continuing basis than at present. At a minimum, this would help improve the ability of municipalities to forecast revenues and manage their cash position. It also might lead to more concerted actions to address delinquent tax accounts. These measures would make it possible for municipalities to improve revenue collection and management.

Legal Reforms. There are many important measures to encourage sound management of local finances that should be adopted as part of new legislation governing local finances. In the area of revenues, this should include the devolution of authority to municipal governments to administer and collect all local taxes and fees. The law also should address existing deficiencies in the structure of local taxes fees. For example, it should include automatic adjustments for inflation to the tax base. The law also should provide greater authority and discretion to local authorities over non-tax revenues, especially in the area of fees for services.

With regard to budget management, the new legislation should include measures regarding the adoption of a balanced budget and of a multi-year capital budget. Budgetary rules should establish the authority to carry forward surpluses derived from all revenue sources, including unused portions of state budget transfers provided as equalization grants. To encourage prudent cash management, the new legislation should set limits on the use on short-term loans from any source to fund operating expenses.

Finally, there are two important additional measures that are necessary to encourage the prudent and efficient management of local finances. The most important is a requirement that there be public participation in the budget process to ensure transparency. If this is to be fully effective, it also will be important to require that municipalities provide complete and timely information on their finances to local citizens and the public in general on a continuing basis.

4. Enhance Local Revenues

As described earlier, the national government has been claiming a growing share of total fiscal resources in recent years. This is a source of growing fiscal stress at the local level. At present, it might be unrealistic to attempt to redress this imbalance. The Government of Bulgaria has ambitious and difficult fiscal targets to achieve. It may not be in a position in the short run to increase the share of national taxes that accrue to

municipalities or to increase the overall amount of transfers.¹⁷ It will be very difficult to establish an equitable and efficient distribution of resources between the national and local levels until there is greater clarity in the definition of local expenditure responsibilities. Conversely, there is no sound argument to support the continued erosion of the relative share of overall fiscal revenues available to municipalities.

Immediate Reforms. The short-term objective should to provide greater stability and predictability to the system of intergovernmental finances. The national and local governments should agree to maintain at least the current share of local revenues and expenditures expressed as a percent of consolidated public sector levels. Even if it is not feasible in the short run to transfer the administration of local taxes and fees to the municipalities, the national government can adopt administrative measures to improve the flow of information to municipalities on local taxes that are administered centrally. This at least should allow for more timely and effective local revenue control and forecasting. The national government can adopt additional administrative measures that will facilitate and accelerate the process of titling municipal property under the new Municipal Property Law. Many of these properties can then be sold or leased to generate additional local revenues.

Legal Reforms. Eventually, the objective should be to match total local revenues to anticipated expenditures based on a clear allocation of responsibilities. There is no objective analysis available at this time that supports an increase or decrease in the local share of total public sector revenues. Organizations representing the interests of municipalities can and should begin to develop the basis for such an analysis now, even if the results might not be applied until later. Once overall requirements are established, the sources of revenues should be structured so as to maximize the portion that flows directly to municipalities. This would include both local taxes and fees and shares of national taxes that are distributed automatically to municipalities. The balance of revenues should consist of general equalization grants from the state budget and matching grants designed to encourage local expenditures that are consistent with national objectives in areas such as environmental quality. The legislation governing local finances should promote the transparency, stability and predictability of revenues that accrue to municipalities.

Additionally, the new municipal finance legislation should establish clear rules that allow municipalities to obtain financing from capital markets for priority investments in local infrastructure. The same legislation also should address other important aspects of a municipal credit market, including the need to set prudent limits on total debt of any given municipality, establish rules governing potential defaults and define clear and explicit limits

¹⁷ For example, in a meeting at the Ministry of Finance, budget officials expressed sympathy with the notion of providing up to a 70 percent share of income tax revenues to municipalities. They indicated, however, that the most they could contemplate in fiscal year 1998 would be a fifty-fifty distribution, given the ambitious targets for the deficit in the consolidated public sector budget.

on state guaranties of local debt. This legislation will have only limited practical effect until municipalities become credit worthy by adopting and putting into practice the measures to address municipal finances described above.

5. Investments

Currently, investments represent a small percent of total local expenditures. This will not change unless the constraints on both the revenue and expenditure side of local finances are addressed. Until municipalities are operating under rules that allow them to generate a consistent operating surplus, it is unrealistic to expect any significant increase in the volume of investments. Such a surplus can finance investments directly or provide the funds to pay the principle and interest on debt issued to finance investments. Grants from the state budget, particularly targeted matching grants with a specific policy objective, should remain in place as an additional form of financing for local investments. Ultimately, municipalities will have to rely on their own means to sustain a high volume of investments. They also will need far more control over the entire investment process, from project design to capital budgeting to construction.

Any change in the volume of investments inevitably will raise the issue of the decentralization of the provision of basic urban infrastructure services. The vast majority of local investments will be in infrastructure systems and facilities. Municipalities legitimately will want local ownership and control over the public utility companies that benefit from their investments. Many investments in infrastructure can be structured to be self-financing. The debt is issued in the name of the public utility. This is an advantage because it does not encumber the limited borrowing capacity of the municipalities themselves. This form of financing will require greater local flexibility in setting user fees.

Immediate Reforms. The objective in the short run should be to make the best of the existing system of financing investments. It is not too early to begin implementing a systematic process of capital investment planning and budgeting at the local level. Concurrently, the rules governing state capital grants should be modified to allow greater local discretion in the choice of projects. As with the formula for allocating equalization grants, the criteria for awarding capital grants should be made more objective and explicit. The criteria also should be revised to provide incentives for inter-municipal cooperation in planning and implementing capital expenditures. The national government also can adopt administrative measures to accelerate the transfer of ownership and control over public utility companies to the municipalities. An existing World Bank project provides funding for investments in water projects if the Government decentralizes ownership of the state water companies.

Legal Reforms. The new legislation on municipal finances should eliminate any *a priori* limits on local investment levels. It also should limit any national level control over project selection to those cases in which municipalities bid on specific state matching

grants. Otherwise, the legislation should leave the capital planning and investment process to the discretion of local governments which should be free to set their own priorities. The existing system of targeted state capital grants should be replaced by a system of matching grants based on objective criteria that refer to regional development and national priorities.

Additional measures should be adopted to expand the role of municipalities in the provision of water, sewer, heating and public transport. Specifically, it would be important to accelerate the transfer to municipalities of ownership of state enterprises providing heating and public transport.

PROPOSED USAID ROLE

Promote Reforms

The first activity that USAID might want to undertake would be to provide direct support to the reform process. This could include efforts to build a consensus on the reform agenda and priorities at the national and local level through conferences and workshops. The agenda recommended by this report is extensive. It will take many years to complete. Some of the most important benefits, such as an increase in the volume of local investments in infrastructure may not accrue until later in the reform process. Therefore, it will be important to stay the course. This will be far more likely if the key participants in the reform process can articulate and agree on an agenda with clear priorities that are shared by all.

In the early phase, the participants will be largely the municipalities themselves and perhaps the MOF. Much of the attention at this point will center on the analysis and discussion of the elements of the reform agenda and of their relative priority and feasibility. In the latter stages, after there is preliminary agreement among the key participants, the emphasis can shift to expanding the dialog to other interested parties, such as other national government ministries, members of Parliament, as well as the general public. This is perhaps the least costly of the proposed activities that USAID can support. It is the one that may have the biggest payoff in the long run.

It will be important to provide direct assistance to MOF and other national ministries on municipal finance reform. It is likely that the MOF will originate many of the most important legislative and policy initiatives. It makes sense to work with them, rather than to be constantly in the position of trying to undo misguided reform proposals emanating from that institution. In addition, there are legitimate national policy concerns regarding municipal finance reform that merit direct attention. This assistance probably should accompany the early dialog on the reform agenda.

Finally, it could be useful to provide support for initial implementation of reforms through the dissemination of any new measures and large scale focused training. Legislative cycles often lead to the enactment of new laws late in the calendar year. Municipalities may have to adapt quickly to new rules of the game.

Second, it would be extremely important to develop the capacity of municipal associations and related NGOs, such as economic think tanks, to formulate and analyze policy options in the area of municipal finance. These are complicated issues for which there are many alternative solutions. The MOF should not be the only institution with the capacity to articulate the options and select from among them. USAID has a program in Poland that supports activities such as these that might serve as a model.



Show Results

It is important to show early results from the reforms in terms of improved financial management and service delivery, as well as expanded local involvement in the structural adjustment process. USAID may want to support a series of pilot projects, similar in design to those currently supported through the USAID Local Government Initiative (LGI) that would show that the reforms can translate quickly into measurable, significant results.

Once municipalities receive more authority to make local expenditure choices, a good pilot project might build on work done earlier by the LGI to implement local efficiency gains in areas of health and education. Given greater local discretion, municipalities would be able to work with directors of local health and education facilities and with the community to “re-engineer” the services in these areas, saving funds in one facet of the services and applying them in another to improve performance.

As municipalities receive more authority, and eventually more resources, it will be important to demonstrate methods to enhance local financial accountability. This can include improved budget formulation, expanded audit activities and the development of disclosure standards and practices that provide timely and accurate information on municipal financial results to the local community and any other interested parties.

Local revenue management already is a major priority of municipalities. Given greater local authority over revenues and, possibly, new sources of revenues, municipalities can focus their attention on maximizing their revenue potential. This can include efforts related to asset management, for example, or to improved revenue forecasting.

Finally, although major sustained increases in the volume of investments are some years away, small *ad hoc* investment deals for local infrastructure might help show how to accelerate that process. Solid waste collection and disposal is an important local service where small investments, such as in better garbage trucks, can have big payoffs. This also is an area where there have been extensive experiences in other east and central European countries with privatization or with competition in the provision of services.

These pilot projects will provide valuable lessons that can serve as the basis for expanding the benefit of the finance reforms to other municipalities.

APPENDIX A

COMMENTS ON DRAFT LAWS

COMMENTS ON THE MUNICIPAL FINANCE LAW

These comments are based on the draft approved by the Council of Ministers on 8 July 1996. There are subsequent versions of this law which were not available for the team to review. Therefore, some of the comments made here may no longer be relevant. Also, any new proposals not included in the draft reviewed here, of course, are not addressed in this report.

- ! The bulk of the proposed law is devoted more to the local budget process, rather than to broader municipal finance issues.
- ! Article 6 (2) and Article 9: The law does not differentiate between *recurrent* and *capital* revenues and expenditures. This economic and budgetary distinction is particularly important for financial analysis in order to determine surpluses in the current account to measure municipal creditworthiness.
- ! Article 6 (3) and Articles. 34-35: The proposed law makes several references to fiscal transfers; however, it does not cover their basic elements. Even if the topic of fiscal transfers merits a separate law, as may be the case, the Law on Municipal Finance should at least establish their source, distribution criteria, and role in municipal finance. The main features of a fiscal transfers system do not appear in the version of the law reviewed for this report. The specifics of a fiscal transfer system should be established in a Law on Municipal Finance or in a separate law. Ideally, the definition of the pool of resources and its distribution criteria should not be left to yearly decisions as part of the annual State Budget Law—as it is currently done.
- ! A law on municipal finance should ideally address the potential issue of unfunded mandates. However, no explicit reference is made in the draft regarding this matter.
- ! Article 10 (1): The law sets a debt limit of ten percent of municipal revenues from credit. This limit has nothing to do with local debt service capacity and/or municipal creditworthiness which are the main parameters for determining the magnitude of potential municipal credit.
- ! Article 10 (2): The law specifies limits for the budget deficit. In principle, local governments should not be running any deficits, but should operate under the principle of balanced budgets that include contingent reserves. Ideally, local



governments would want to operate always on the principle that they want to end the year with a small surplus.

- ! Article 3 (1) states that the municipality has an *independent* budget, but Art. 11 and 12 link the local budget approval to the approval of the state budget. The approval of municipal budgets should be practically independent of the approval of the state budget.
- ! Article 19 (4): The administration of local revenues continues to be centralized in the MOF. The authority for local tax collection and fees should be devolved to the local governments.
- ! Current budgetary classification is based on current practice which should be reviewed. Budgetary classification should be adequate to compute surpluses or deficits in current and capital accounts in order to determine municipal credit worthiness.
- ! Article 35 (3): It is not quite clear what the implicit matching arrangements are for targeted funds. The level of co-financing and financial conditions should be transparent.
- ! Article 39 (3): It should establish a limit on state guarantees for credits denominated in foreign exchange.

COMMENTS ON THE LAW ON LOCAL TAXES AND FEES

These comments are based on the draft of the Law on Local Taxes and Fees that is dated January 6, 1997. The Ministry of Finance apparently has a new version of this law. As with the Municipal Finance Law, some of the comments made here may no longer be relevant. Also, any new proposals not included in the draft reviewed here, of course, are not addressed in this report.

General Comments

- ! The law should constitute an "enabling act," which describes the authority of local governments to impose taxes and fees. This review is limited by the following factors:
 - The fiscal system in which this operates has not been analyzed by this reviewer. Therefore, these comments do not assess the fiscal capability of local governments nor the relationship between these taxes and fees and those that may be imposed by other units of government.

- The law describes the powers of "municipalities" without reference to other units of local territorial administration. It is recognized that reforms are consolidating the number of local administrative units and that "municipalities" are the principle unit of local administration. However, the term "municipality" should be defined by the law. If the term does not refer to all types of local administrative units comprehensively, then the law should be rationalized according to the fiscal capabilities of various types of local administrative units.
- ! The draft law is clearly written and well organized. It is helpful that the provisions of each section follow a consistent pattern (i.e. "scope", "declaration", etc.) .
- ! Several of the subjects of taxation in the draft law are mobile, such as the vehicle tax, or may be located in a variety of local jurisdictions, such as inherited property. This complicates assessment and collection of such taxes by an individual local authority. Therefore, such taxes should be collected by a national authority and then allocated to individual local authorities in an appropriate manner.
- ! Chapter Three contains authority to impose fees. This is for the use of publicly owned property. There is justification for defining the upper limits of taxes, in order to achieve uniformity between local jurisdictions. However, the same justification does not exist for limiting the imposition of fees (except, perhaps road fees). Instead, charges for the use of public property should be based on demand and costs. Therefore, greater local discretion should be allowed for imposition of fees by local authorities.

Specific Comments

Article 2. This provision is mandatory, requiring these taxes to be assessed. It is recommended that the section allows the local units to exercise discretion regarding whether a specific tax is assessed and, if so, the rate of the tax (within limits defined in the law).

A vehicular tax is on property that is movable and therefore may not be appropriate for assessment and collection by local administrative units.

Since the method of assessing and the limitations on the assessment of these taxes are described in subsequent sections, this article should specifically state "As described in Chapter Two of this law,..."

Article 3. This provision does not clearly state that these "fees" are for the use of publicly owned property or services provided by the municipality. Therefore, the distinction between "tax" and "fee" is also unclear. A tax is a levy imposed upon a private activity, ownership or privilege. A fee is a payment made in exchange for the receipt of a privilege, right or service provided by a governmental unit.

Since the method of assessing and the limitations on the assessment of these fees are described in subsequent sections, this article should specifically state "As described in Chapter Three of this law,..."

There is a numbering error in Article 3.

Article 4. This article is unclearly stated (perhaps a translation problem).

Article 6. (1) This states that municipality councils may exercise discretion in setting the tax rate, within the limits of this law. This is an important provision, in that local units should be able to adjust rates based upon local needs and conditions.

(2) The relationship between this provision and Article 3 (authorizing assessment of fees) and Chapter Three (describing the limits of fees) is unclear. If it is merely redundant, it should be eliminated. If it supplements these other provisions, it may result in undermining the more specific limitations and conditions set forth in the law.

(3) There should be careful limitations upon the granting of exemptions, in order to avoid favoritism.

Article 7. A tax system relies upon its stability and facial validity. Therefore, this article should be carefully drafted to limit the powers of the Minister of Finance to invalidate a local tax and restrict the time during which the Minister may act.

(1) This provision does not state the purpose of referring the resolution to the Minister of Finance or the scope of review.

(2) The provision should limit the time during which the Minister may invalidate a tax. Otherwise, a tax could be perpetually vulnerable to invalidation, and could raise difficult questions about the refund of invalidated taxes that have been collected.

Article 8. This article undermines the provisions of this law which (a) establish limits of taxes and fees and (b) provide municipal councils with discretion to set rates.

It is recommended that this article either be eliminated or that this power be clearly described as only advisory and without legal effect.

Article 11. This article describes the things on which the tax is assessed. Therefore, the types of property that are to be assessed should be specifically identified. Certainly, if there is a real estate law (or section on real property in the Civil Code), it should be referenced and its definitions of categories of property should be identified.

It is likely, however, that there is not a precise definition of real property. Therefore, the categories to be taxed in Section I should be defined by such terms as land, building and other fixtures. The article should then describe whether these are taxed separately or cumulatively.

Article 12. This article implies that leases are to be taxed. Some laws allow the assessment of real estate taxes on the ownership (paid by the owner) and, in addition, a tax on the possessory right if the land is used by a person other than the owner (paid by the lessee).

As written, the article assesses the tax on either the user or the owner. This raises several questions.

- ! First, under Bulgarian law there is probably the right to lease only part of the land or to lease the building but not the land. In this case, the application of the article will be confusing.
- ! Second, the obligation to pay the tax should always be on the owner, unless the law creates a separate leasehold tax. This allows the owner to shift the obligation to the lessee by terms of the lease, but always makes the obligation collectible by a person who can be easily identified. In addition, if the tax is delinquent, it can then be enforced as a lien against the property (an obligation of the owner).
- ! Finally, the article does not clarify whether the casual user (at-will tenant), easement holder or month-to-month tenant is the obligee, or whether such situations make the owner the obligee.

Article 13. A better practice is not to allow such proportional assessment. The assessment is against the land, and is enforced as a lien against the land. Therefore, it is left to the owners to decide how to divide the obligation among each other.

Article 14. This is an important provision.

Articles 15-19. These articles place the burden of reporting on the property owner or user. This raises several problems.

If, as provided by Article 12, the obligation for payment is the user, there may be confusion as to whether the owner or user is obligated to report. This is especially true if the user has rights to use only a portion of the property.

These articles should be reconciled with Articles 21 - 23 which set the value of the property. These articles rely on self-reporting and self-calculating of the value of the

property and the application of the tax rate to the assessed value. This is probably impractical. A better system would be for the tax officials to calculate the amount of tax and maintain a record of the assessed valuation.

It is recognized that Article 25 may place responsibility for calculation and notification on government officials, but this is not clear when Article 25 is reconciled with the prior sections.

These provisions and other provisions of this Chapter do not adequately provide for enforcement of the tax, such as the imposition and execution of a lien on the property in cases of delinquency.

Articles 21-23. These articles should be changed to set forth a clear and objective basis for valuation of the property. Article 21 states a variety of factors, leaving room for many interpretations of the value. Article 22 distinguishes between the value of the land and the value of fixtures. Lacking a "market value" at this point, it may be necessary to identify criteria that determine value. However, it is important that these criteria lead to a clear and objective establishment of value.

The articles should provide for a public record which contains the assessed valuation of the property.

Article 24. This article does not provide local officials with any discretion in the establishment of tax rates. It is recommended that the article establish a maximum rate, and allow local officials to set a rate that is within that maximum.

Articles 31-43. The Inheritance Tax is treated as a local tax. This raises several problems that are not resolved by the draft law:

- ! Property of a deceased person may be located within more than one local jurisdiction. The draft law does not indicate which local government shall have jurisdiction to collect or how the tax proceeds shall be shared among local jurisdictions.
- ! The draft law does not indicate which local jurisdiction has the duty to set the tax rate, assess the value or collect the tax.

Article 35(1)-1. This refers to assessed valuation of the property. However, Chapter Two does not clearly establish a public record that states assessed valuation.

Article 38. This article is unclear in its application. It is recommended that the tax be assessed by the government against the estate, and that the heirs have the responsibility of apportioning the tax among themselves.

To reduce administrative burden, it is recommended that small estates be exempt from taxation. This would require the reporting of inheritance by all heirs, but provide for an exemption from payment of the tax for estates below a defined amount.

Articles 44-52. To reduce administrative burden, it is recommended that small gifts be exempt from taxation.

Articles 53-61. These articles establish a sales or transfer tax. If it is the only sales tax that is used by national and local authorities, consideration should be given to expanding the types of property or transactions to which it applies. If it is not the only sales tax, consideration should be given to whether it is wise policy to impose a higher tax rate on the types of property identified by Article 53.

Articles 57 and 59. These articles standardize the tax rate among local jurisdictions. This is a good practice, in that it avoids influencing the location at which a transaction takes place.

Articles 62-69. It appears that Articles 63 and 69 make vehicles taxable at the domicile of the owner of the property. This location is not necessarily the place at which the vehicle is used. However, since this is a tax, rather than a fee; its purpose is not to compensate a local authority for the burden that the use imposes, such as maintenance of a harbor for ships or roadways.

The large number of categories of vehicles may complicate administration of the tax.

APPENDIX B

Appendix B, Table 1

Local Government Real Revenues and Expenditures in Bulgarian Leva ('000)^a

Real Values	1991	Jan-June 1992	1993	1994	1995	1996
<i>Revenues</i>						
Tax Revenue	226,194,000 73.19	68,776,667 49.34	110,200,000 47.84	60,984,168 34.90	57,934,882 38.06	52,994,779 47.28
Shared Revenue	223,510,000 72.32	67,671,111 48.67	107,518,000 46.68	57,072,707 32.66	54,073,096 35.52	49,813,388 44.45
Other Tax Revenue	2,684,000 0.87	1,105,556 0.66	2,682,000 1.16	3,911,461 2.24	3,861,787 2.54	3,181,391 2.84
Non-Tax Revenue	10,928,000 3.54	12,150,000 4.42	8,920,667 3.87	30,355,646 17.37	27,409,173 18.00	19,941,387 17.79
Fees	4,918,000 1.59	2,511,111 1.80	6,283,333 2.73	17,488,550 10.01	14,215,509 9.34	9,713,008 8.67
Other Non-Tax Rev.	6,010,000 1.94	9,638,889 2.62	2,637,333 1.14	12,867,100 7.36	13,193,664 8.67	10,228,379 9.13
Transfers	71,918,000 23.27	39,410,000 46.25	111,232,000 48.29	77,519,571 44.36	64,018,733 42.05	37,099,227 33.10
Borrowings	—	—	—	5,887,168 3.37	2,869,591 1.89	2,041,742 1.82
Temporary Non-Int.	—	—	—	2,737,307 1.57	1,959,482 1.29	2,103,311 1.88
Int. Bearing from Fin. Inst.	—	—	—	2,440,671 1.40	182,349 0.12	-74,200 -0.07
Bonds	—	—	—	709,186 0.41	727,760 0.48	12,631 0.01
Total	309,040,000 100.00	120,336,667 100.00	230,352,667 100.00	174,746,554 100.00	152,232,380 100.00	112,077,135 100.00
<i>Expenditures</i>						
Education	100,460,000 33.84	37,144,444 32.54	85,806,667 37.02	56,445,214 32.49	48,865,820 32.43	34,780,633 31.21
Culture	8,380,000 2.82	2,722,222 2.39	6,706,667 2.89	4,984,950 2.87	4,700,118 3.12	3,185,406 2.86
Health Care	82,700,000 27.86	33,588,889 29.43	77,586,667 33.47	53,607,168 30.86	45,958,527 30.50	32,505,260 29.17
Housing & Communal Service	49,640,000 16.72	19,966,667 17.49	22,133,333 9.55	28,942,621 16.66	24,356,571 16.16	17,747,105 15.93
Social Welfare	21,080,000 7.10	9,288,889 8.14	24,213,333 10.45	16,813,479 9.68	14,148,962 9.39	9,678,484 8.69
Local Admin.	12,740,000 4.29	4,333,333 3.80	7,360,000 3.17	9,395,111 5.41	9,062,113 6.01	6,754,192 6.06
Other	21,840,000 7.36	47,088,889 6.21	8,006,667 3.45	3,542,325 2.04	3,590,509 2.38	6,775,591 6.08
Total Expenditure	296,840,000 100.00	114,133,333 100.00	231,813,333 100.00	173,730,868 100.00	150,682,620 100.00	111,426,671 100.00

Note

^a Numbers have been inflated to 1996 prices (base year).

Source: Ministry of Finance, Bulgaria.

Appendix B, Table 2

Summary of Local Government Expenditures in Bulgarian Leva (millions), 1996

	1990	1991	1992	1993	1994	1995	1996
<i>Local Government Expenditures</i>							
Total Expenditure	5,599	14,863	26,181	33,695	48,758	68,033	111,294
Current Expenditure	4,888	12,855	22,625	30,380	44,390	63,044	105,032
(as a % of total)	87.30	86.49	86.42	90.16	91.04	92.67	94.37
Capital Expenditure	711	2,008	3,556	3,315	4,369	4,989	6,262
(as a % of total)	12.70	13.51	13.58	9.84	8.96	7.33	5.63
<i>Expenditures of Consolidated National Budget - Local Budgets</i>							
Total Expenditure	25,028	54,497	81,591	133,877	235,905	360,607	840,566
Current Expenditure	24,291	53,429	78,713	130,570	229,767	347,049	818,269
Capital Expenditure	737	1,068	2,878	3,307	6,138	13,558	22,297
GDP	45,390	135,711	200,832	298,934	522,233	871,396	1,660,200
<i>Expenditures of Consolidated National Budget + Local Budgets</i>							
Total Expenditure	30,627	69,360	107,772	167,572	284,663	428,640	951,860
Current Expenditure	29,179	66,284	101,338	160,950	274,157	410,093	923,301
Capital Expenditure	1,448	3,076	6,434	6,622	10,507	18,547	28,559
<i>Local Expenditures as a percent of CNB&LB</i>							
Total Expenditure	18.28	21.43	24.29	20.11	17.13	15.87	11.69
Current Expenditure	16.75	19.39	22.33	18.88	16.19	15.37	11.38
Capital Expenditure	49.10	65.28	55.27	50.06	41.58	26.90	21.93
<i>Expenditures of LB as a percent of GDP</i>							
Total Expenditure	12.34	10.95	13.04	11.27	9.34	7.81	6.70
Current Expenditure	10.77	9.47	11.27	10.16	8.50	7.23	6.33
Capital Expenditure	1.57	1.48	1.77	1.11	0.84	0.57	0.38
<i>Expenditures of CNB as a percent of GDP</i>							
Total Expenditures	55.14	40.16	40.63	44.78	45.17	41.38	50.63
Current Expenditure	53.52	39.37	39.19	43.68	44.00	39.83	49.29
Capital Expenditure	1.62	0.79	1.43	1.11	1.18	1.56	1.34

Source: Ministry of Finance, Bulgaria.

APPENDIX C

MATERIALS AND DOCUMENTS REVIEWED

<i>“Quantitative Analysis and Evaluation of Municipal Budgets in Bulgaria”</i>	Stefan Ivanov, PhD
Datasets on Local Revenues/Expenditures by Line Items and Functions for 1994-1996	MoF
Data on the Local Budget Implementation for 1996; Data on the Planned Budget for 1997; Data on the Extrabudgetary Accounts for 1996	Stara Zagora
Data on the Local Budget Implementation for 1996; Data on the Planned Budget for 1997; Data on the Extrabudgetary Accounts for 1996	Blagoevgrad
Datasets on the Consolidated National Budget 1990-1996	Budget Directorate, MoF
Law on Municipal Finance - Draft, as prepared by an expert team headed by Tsonyo Botev	Tsonyo Botev, Parliamentary Local Government Commission
BULGARIA 2001 PROGRAMME of the Government of Bulgaria 1997 - 2001	
Conference <i>“Municipal Finance Reform: Opportunities and Perspectives”</i> , Sofia, 2-4 July 1997, Materials:	
Strengthening Local Government through Finance Decentralization, The Need of Legislation Reform (Prepared by a working group of NAPFO)	
Improving the Scope and Function of the Internal and External Control of Public Finance (Prepared by a working group of NAPFO)	
Problems of Municipal Finance in Bulgaria (Position of the Ministry of Finance on Financial Decentralization)	

Real Exchange Rate Overvaluation in a Currency Board Arrangement: Consequences and Solutions (Emil Dimitrov, Head of BNB Balance of Payments and Foreign Debt Department)

Mayors Urge Upped Municipal Tax (by Toni Alexova, Capital Press, No. 28, 14-20 July, 1997)

Proposals of the Member Municipalities of the National Association of Municipalities in the Republic of Bulgaria

Work Group 2: Municipal Budgets: Item Structure, Revenues and Expenses, Related Authority

Discussion Results and Recommendations for Legislative Reform

Record of Proceedings

Other Materials:

Ministry of Finance Ordinance No. 4 (March 20 1995)

National Budget Procedures Act (Prom. Official Gazette No. 67 of August 6, 1996 by Presidential Decree No. 270 dated July 25, 1996)

Regulations for the Implementation of the National Audit Office Act (Prom. State Gazette No. 28/02.04.1996)

National Audit Office Act (as Amended - Promulgated in the Official Gazette No. 71 of August 11, 1995 by Presidential decree No. 232 dated August 3, 1995)

Public Procurement Act (Prom. Official Gazette No. 9 of January 31, 1997 by Presidential Decree No. 74 dated January 28, 1997)

Local taxes and Fees Act (Draft January 6, 1997)

Regulations for the implementation of the Excise Tax Act (Prom. Stat Gazette No. 27/31.03.1994, Amended SG Nos 86/1995 & 46/1996)

Tax Administration Act (Prom. State Gazette No. 59/09.07.1993, Amended SG No. 19/1996)

Excise Tax Act (Prom. State Gazette No. 19/02.03.1994, Amended SG Nos. 58 & 70/1995; 21 & 56/1996)

Government Collections Act (Prom. SG No. 26/26.03.1996)

Municipal Property Act (Prom. SG No. 44/21.05.1996, Amended SG No. 104/1996; 55/1997)

State Budget of the Republic of Bulgaria for 1997 Act (Prom. SG No. 52/01.07.1997)

Transformation and Privatization of State Owned and Municipal Enterprises Act (Prom. SG No. 38/08.05.1992, Amended SG Nos 51/1994; 45, 57 & 109/1995; 42, 45, 68 & 85/1996; 55/1997)

Local Taxes and Fees Act (Prom. Izvestiya, No. 104/28.12.1951, last Amendment SG No. 55/1997)

Value Added Tax Act (Prom. SG, No. 90/22.10.1993, Amended SG No. 57/1995; 56 & 104/1996; 51/1997)

Tax Procedures Act (Prom. SG No. 61/16.07.1993, Amended SG No. 20/1996; 51/1997)

Tax on profits Act (Prom. SG No. 59/12.07.1996, Amended SG No. 110/1996; 16 & 49/1997)

APPENDIX D

LIST OF PERSONS INTERVIEWED SEPTEMBER 11 TO 23, 1997

NAMES	POSITIONS
RAYNA KOSSEVA	Manager of the Financial Department of the Stara Zagora Municipality
ROZA BAKALSKA	Expert at the Financial Department of the Blagoevgrad Municipality
BOYKO GEORGIEV	Head of Local Finance Directorate of MoF
LYUBOMIR DATSOV	Expert at the Budget Directorate of MoF
Mr. ZLATKOV	Expert at the National Accounting Directorate of MoF
TINKA POPOVA	Expert at the Capital Expenditure Department of the State Expenditures Directorate of MoF
EMIL SAVOV	MTKK Expert on Local Finance, Local Governance
DAYAN KAVRAKOV	MTKK Expert on Local Finance, Local Governance, Acting Executive Director of the National Association of Public Financers
AKSENIA MONOVA	Head of Local Taxes and Fees Department of MoF
ELAINE PATTERSON	World Bank Senior Project Officer
THIERY LIPPERT	EU Delegation, Consultant on Large Taxpayers Project to MoF
MAYA KOLEVA	MTKK Expert on Local Finance, Local Government
SAVIN KOVACHEV	Ministry of Regional Development and Construction, Head of Local Government Department
GINKA CHAVDAROVA	Executive Director of the National Association of Municipalities of the Republic of Bulgaria
GINKA KAPITANOVA	Local Government Reform Foundation, Bulgaria
TSONYO BOTEV	Parliamentary Local Government Commission
NIKOLA BABAMOV, MILAN PETROV	Councillors to the Parliamentary Budget Commission